

Chapter 23: Worksheet mark scheme (36 marks)

(Students may use the official IB Business and Management formulae list.)

- 1** What is the difference between profit and profitability? **(2)**

Profit is sales revenue less the costs, whereas profitability is the relationship between gross profit or net profit and sales revenue, expressed as a percentage.

- 2** Give **three** ways in which a business may increase profitability. **(3)**

- reduce average cost per item, e.g. by reducing the unit cost of raw materials, wages or through economies of scale
- reduce selling costs
- raise prices
- change production methods to more efficient ones

Profitability does not increase simply by selling more, unless costs per item are reduced.

- 3** A firm's gross profit margin is 40%. Explain what this means. **(2)**

This means that after cost of goods sold (COGS) has been deducted from sales revenue, 40% of sales revenue is left over to pay overheads. COGS generally represent direct, variable costs of production.

- 4** Define 'capital employed'. **(2)**

This is the long-term money invested in a business. It includes shareholders' funds as well as long-term liabilities (non-current liabilities).

- 5** Why is return on capital employed (ROCE) a useful efficiency ratio? **(2)**

It shows the rate of return on money invested in a business for the long term, so it is useful because it enables an investor to compare an investment in a particular business against investment in other long-term options, e.g. a bank term deposit.

- 6** Most businesses aim to have a current ratio (CR) above 1.0. Why is this? **(2)**

The CR shows the ability of the business to repay its current liabilities using only its current assets. If the CR is above 1.0, it shows that the business can more than repay its current liabilities by liquidating its current assets. If the CR were below 1 it is possible that the business would be called upon to repay current liabilities without having the liquid funds to do so.

- 7 Why does the acid test deduct the value of stocks from current assets? (2)

Stocks have a very uncertain value if the business tried to sell them quickly. It is therefore more conservative to exclude them when analysing the liquidity.

- 8 List **four** things a business could do to improve its liquidity. (4)

- do not replace stocks when they are used and sold
- give customers shorter credit terms
- sell off stock for cash and do not replace it
- ask suppliers for longer credit terms
- switch to a JIT stock management system

Switching from LIFO to FIFO may make liquidity look better because the value of stock will be higher if supplies have been going up in unit cost, but will not in reality change anything.

Taking a long-term loan and using it for short-term working capital purposes may make the liquidity look better, but it is inadvisable to mismatch in this way.

- 9 Why does the stock turnover ratio use cost of goods sold instead of sales as the denominator? (2)

Stock is valued at cost price and therefore has to be compared against a year's worth of stock in order to calculate how many days' worth of stock is available.

- 10 Bearing in mind your answer to question 9, why do debtor days use sales turnover as the denominator? (2)

Debtors bought their goods at the selling price and so the outstanding bills have to be compared with the value of sales to see how many days' worth of debtors there are.

- 11 Give **two** reasons why the dividend yield of a business may go up. (2)

- dividends per share rise
- share prices fall

- 12 State **two** factors that may determine whether a company pays a bigger dividend than other similar companies. (2)

- Profits may rise and so shareholders may vote to raise dividends in proportion.
- Shareholders may vote to pay out a bigger proportion of profits as dividends.

- 13 Explain why the dividend yield is a useful ratio for investors. (2)

It shows what percentage of the share price is returned in dividends, so this can easily be compared with the return on alternative investments.

14 What does the dividend yield not show? **(1)**

It does not show the effective return on any capital appreciation (increase in the value of the shares).

15 a Bearing in mind your answer to question 4, what does the gearing ratio show? **(2)**

It shows the proportion of the long-term investment of the company which is made up of long-term loans.

b Capital employed in Geldo Ltd consists of long-term bank loans and shareholders' funds. The gearing ratio is 50% and Geldo asks the bank to give another long-term loan. Give **two** reasons why the bank does not want to lend more. **(2)**

- The higher the ratio, the greater the risk.
- The bank would not want to have more funds at risk long term than shareholders are willing to risk.
- Debt interest may swallow a lot of the profits.
- Large loan repayments may be impossible to make in the future from short-term liquidity (cash).

16 Give **two** reasons why ratio analysis may have limitations. **(2)**

- it is based on past data
- inter-firm comparisons may be inaccurate unless the firms are in the same business
- businesses may have significant intangible assets that have no balance sheet value
- they give indications of where problems may lie but do not offer solutions
- they only examine accounting items and do not look at environmental audits or ethical issues